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DIRECTORATE OF INTELLIGENCE

Intelligence Memorandum

Mexico: Recent Financial Trends

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CENTRAL INTELLIGENCE AGENCY
Directorate of Intelligence
April 1971

INTELLIGENCE MEMORANDUM

Mexico: Recent Financial Trends

Introduction

1. Long noted for its financial stability and rapid economic growth, Mexico suffered a sharply increased (although not extremely high) inflation rate and further deterioration in its trade balance in 1970. These events have rekindled some of the uneasiness that followed the student riots and intense investment activity of 1968, and observers are wondering whether Mexico is deviating only temporarily from its established course or is entering a more troubled period. Moreover, economic policy may be altered in some ways by the new administration that took office in December 1970, continuing the Institutional Revolutionary Party's 40-year domination of political power. Initial statements by President Luis Echeverria suggest that he may undertake major social programs, at some cost to financial stability or economic expansion. This memorandum examines Mexican financial trends during the past two years and assesses the short-term outlook.

Discussion

Background

2. For more than three decades Mexico has been the most economically successful state in Latin America. Its annual real economic growth

Note: This memorandum was prepared by the Office of Economic Research and coordinated within the Directorate of Intelligence.

rate since 1935 has averaged 6% -- probably the world's highest for the period -- and in 1969-70 the rate was above average. Although the early stages of growth were accompanied by considerable inflation, price rises generally have been very moderate since Mexico's last currency devaluation in 1954. Indeed, financial stability has been a major factor in Mexico's economic achievement.*

Price and Wage Trends

3. In 1970 the inflation rate reached a level that has caused some concern, even though few countries had a much better record. The wholesale price index, Mexico's most commonly used price measure, rose by 6%; this rate of increase was more than twice that in 1969 and the largest since 1955 (see the chart). The consumer price index, which covers many goods with controlled prices, rose by nearly 5% -- also the highest figure in more than a decade. Foodstuffs accounted for much of the rise in wholesale prices in 1970, but other consumer goods prices also showed conspicuous gains, as shown in the accompanying tabulation.

	Increase (Percent)	
	1969	1970
General index	2.6	6.0
Food	2.5	7.4
Unprocessed	2.3	8.7
Processed	3.3	3.1
Other consumer goods	3.8	6.7
Producer goods	2.0	4.1

4. Stepped-up inflation was more a result of increases in import prices -- themselves resulting from higher inflation rates worldwide -- and of agricultural problems than of excessive wage

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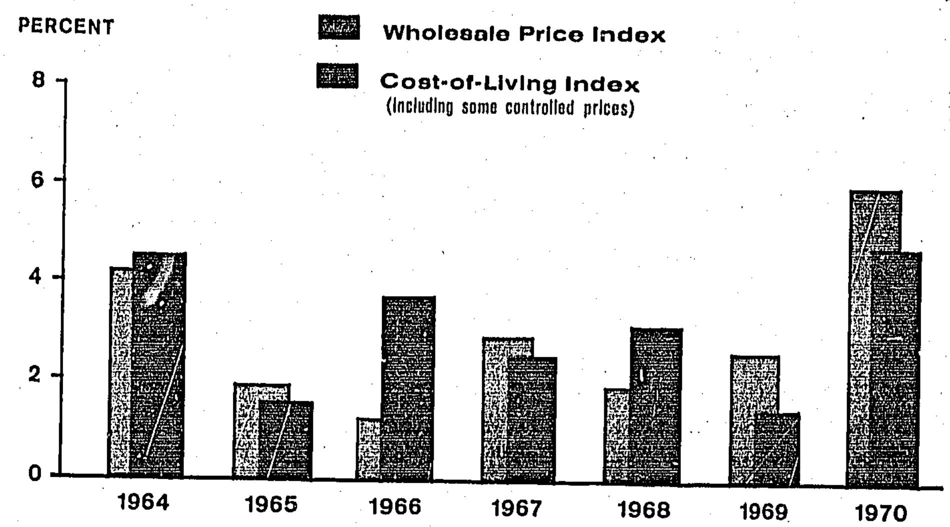
Increases in Prices



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gains or incautious budget policy. An 18-month drought which ended in July 1970 reduced the growth of farm output from an average of 4½% during 1950-68 to about 2% in 1969 and 3% in 1970 -- both gains trailing population growth. Despite improved agricultural growth and corn imports totaling 1 million metric tons, price pressure intensified in 1970 because large carry-over stocks were depleted in 1969.

5. Recent wage increases apparently have not significantly exceeded productivity gains. The two-step increase in minimum wages in 1969-70 amounted to about 14%, and overall industrial wages probably rose somewhat faster than that, even though many handicraft producers ignore the legal minimum. The May 1970 labor code increased

fringe benefits and overtime payments and requires large employers to provide housing for their workers over a period of years. Some businessmen claimed initially that the code would greatly increase their labor costs, but estimates now are that it will boost these costs by less than 10% -- in many cases, less than 5%.

Public Finance

6. The central government has continued to finance a substantial part of its investments through loans but has not resorted to inflationary central bank credit.* During its last year in office, the Diaz Ordaz administration sharply raised investment outlays in an effort to complete such projects as the Mexico City subway, port expansion on the Pacific Coast, and irrigation systems in the northwest. This drive, however, did not strain the budget, because operating expenses were tightly controlled and continued rapid economic growth and improved tax collection boosted revenues appreciably. The ratio of the budget deficit to total spending declined from 16% in 1968 to 14½% in 1969 and probably fell further in 1970.

7. Credit expansion in 1969-70 continued at or a little above the average 17½% rate of preceding years, and the increases in the money supply do not seem excessive, considering the high economic growth rates. Anticipating increased public borrowing from the private sector in 1970, the Bank of Mexico restricted credit as an anti-inflationary measure. This action helped to hold the growth in money supply to an estimated 10% -- a level that compares favorably with earlier years (as the following tabulation shows) and normally would permit reasonable price stability.

* *The Bank of Mexico is used only as a channel for placing government securities in commercial banks.*

	Increase (Percent)		
	Money Supply	Output	Wholesale Prices
1964	16½	11½	4
1965	7	5½	2
1966	11	7½	1
1967	8	6½	3
1968	13	8	2
1969	11	7	2½
1970 estimated	10	7½	6

Foreign Payments Developments

8. Growing trade deficits have caused concern despite continued balance-of-payments surpluses because capital receipts are highly important to Mexico. These inflows obviously would suffer if investors feared that Mexico's impressive 17-year record of currency stability was nearing an end -- or merely that intensifying problems and less exuberant growth lie ahead. At least a few Mexican businessmen and foreign investors were alarmed by the rise in the trade deficit to $1.1 billion in 1970 -- some $400 million more than in 1969 (see the table). In only four years, the trade and current account deficits have both jumped by more than 140%. But with net capital receipts approaching $1 billion in 1970 (an all-time high), Mexico still registered a $100 million payments surplus.

9. The drought was a major determinant of 1970's poor trade performance as well as the price rise. Although sales of vegetables and other irrigated crops increased considerably, overall crop exports declined from $453 million in 1969 to $397 million in 1970 and total export earnings dropped slightly, in contrast to the previous year's large gain. A 37% drop in cotton shipments -- Mexico's leading export -- reflected both poor weather and a 20% cut in acreage following increases in support prices for other crops. Because of the drought, Mexico became a net grain importer for the first time in many years; public sector imports, mostly foodstuffs purchased by the National Company of

Mexico: Balance of Payments

Million US $

	1966	1967	1968	1969	1970 Provisional
Exports (f.o.b.)	1,163	1,104	1,181	1,385	1,368
Imports (c.i.f.)	1,605	1,749	1,960	2,078	2,456
Trade balance	-442	-645	-779	-693	-1,088
Net receipts from tourism	192	200	238	293	310
Net receipts from border transactions	204	231	263	260	294
Net receipts from other service transactions	-310	-406	-354	-332	-381
Current account balance	-356	-620	-632	-472	-865
Net receipts of long-term capital	213	346	265	646	541
Other capital and errors and omissions	149	314	416	-126	426
Capital account balance	362	660	681	520	967
Payments balance	*6*	*40*	*49*	*48*	*102*

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Popular Subsistence (CONASUPO), increased 37%. Private imports, mostly capital goods and raw materials for the thriving industrial sector, rose by 13%, partly because of higher prices abroad.

10. Although increasing handily in 1969, net receipts from tourism felt the combined influence of the US recession and Mexican prosperity in 1970. Earnings from foreign tourists reached $575 million (a 9% gain compared with 22% the year before), while Mexican tourist expenditures abroad increased 13%, to $265 million. Net receipts from border transactions rose some $34 million in 1970 after having declined in 1969. Increased profit remittances and other service payments, however, largely offset gains from tourism and border transactions.

11. Preliminary estimates indicate that much of the 1970 capital inflow consisted of short-term funds, whereas there was a net outflow of short-term capital in 1969. After an unusually large gain the year before, net receipts of long-term capital decreased by about $100 million in 1970 because high interest rates discouraged the government from floating bonds abroad. Capital movements nevertheless remained very favorable and allowed Mexico to increase its gross foreign exchange reserves from $718 million in December 1969 to $820 million in December 1970 -- an amount equaling about four months' imports.

Policy Orientation of the Echeverria Government

12. "It would be contrary to the best of our heritage," said President Echeverria in his inaugural address on 1 December 1970, "if we were to encourage the conservative trends that have developed out of a long period of stability." Although Echeverria stressed that he would maintain a free foreign exchange system and protect the peso's value, the economic portion of his speech was replete with promises of income redistribution, further agrarian reform, and new social infrastructure projects. In subsequent statements, he asserted that profit margins must be reduced to give labor a greater share of the national income and that investment funds should be shifted away from export-oriented commercial farms in the northwest to the subsistence plots of central Mexico.

13. Few would deny that Mexican governments have neglected income redistribution and other social goals, inasmuch as the real income of the lowest fifth of the population appears to have declined during the remarkable general advance of the past 20 years. But the fact remains that a vigorous attack on the poverty problem almost certainly would have a cost, in terms of economic growth and financial stability. Rigid enforcement of the new labor code and more progressive tax measures, for example, would probably inhibit investment; greater support for subsistence farming would hurt urban food supplies and exports; and ambitious public works projects would strain the government budget.

14. It is too early to say definitely what course the Echeverria government will finally pursue and how rapidly it will move; the inaugural address and early legislation offer an uncertain basis for prejuding a six-year administration. Even if Echeverria shows more regard for the poorest Mexicans than did his recent predecessors, he probably will balance their claims against the need for growing economic capability. As a pragmatist proud of Mexico's economic record, he probably realizes that continued rapid expansion and conservative financial policy can serve the goal of social reform.

Short-Term Prospects

15. Although some uncertainty surrounds the new government's policies, the financial outlook through 1972 seems generally favorable. Prospective increases in government expenditures should be covered by various recently passed tax measures. The inflation rate is likely to be higher than customary -- partly because subsidized prices for certain items are being abandoned -- but price rises probably will be smaller than in 1970. The Mexican president is in a strong position to moderate inflation by "jaw-boning," as demonstrated by his successful effort in February to have Mexico City food prices rolled back.

16. Given average crop conditions and no new protectionist measures in Mexico's major markets, serious balance-of-payments problems are unlikely

through 1972. The trade deficit should drop substantially in 1971; more favorable weather should reduce supply constraints on agricultural exports and the need for major food imports. Cotton exports will probably remain depressed, but farmers producing meat, fruit, and vegetables for export show little fear of Echeverria's agrarian reforms and predict continued sales expansion. Manufactured exports, which stagnated in 1970 after a large rise in 1969, promise to increase moderately, aided by the new export incentives introduced in March 1971. Through its licensing procedures, the government has a means of quickly restraining imports should that be necessary. Even if Mexico does not restrict spending abroad by its own citizens, net tourist earnings can be expected to increase as the United States recovers from the recession. Mexico's record of stability and continuing profit opportunities should assure sufficient capital inflows to cover the reduced current account deficits that are in prospect.

17. Devaluation of the peso by the end of 1972 cannot be ruled out entirely, considering the rise in Mexico's price level since 1954 and the advantage of taking such action prematurely -- that is, before it clearly is necessary and begins to be anticipated by investors. Even so, devaluation seems unlikely. The main price increases occurred in 1955-58; these totaled about 43%, as measured by the wholesale price index, and caused only temporary balance-of-payments strains. During the past decade, the gain in Mexican wholesale prices has merely approximated that of US prices. Exports of manufactured goods have now reached some $300 million, or twice as much as in 1962, and their growth rate has held up well. Moreover, the balance of payments remains strong, and Mexican officials unquestionably attach great importance to the country's reputation for financial stability and would be extremely reluctant to undermine it.